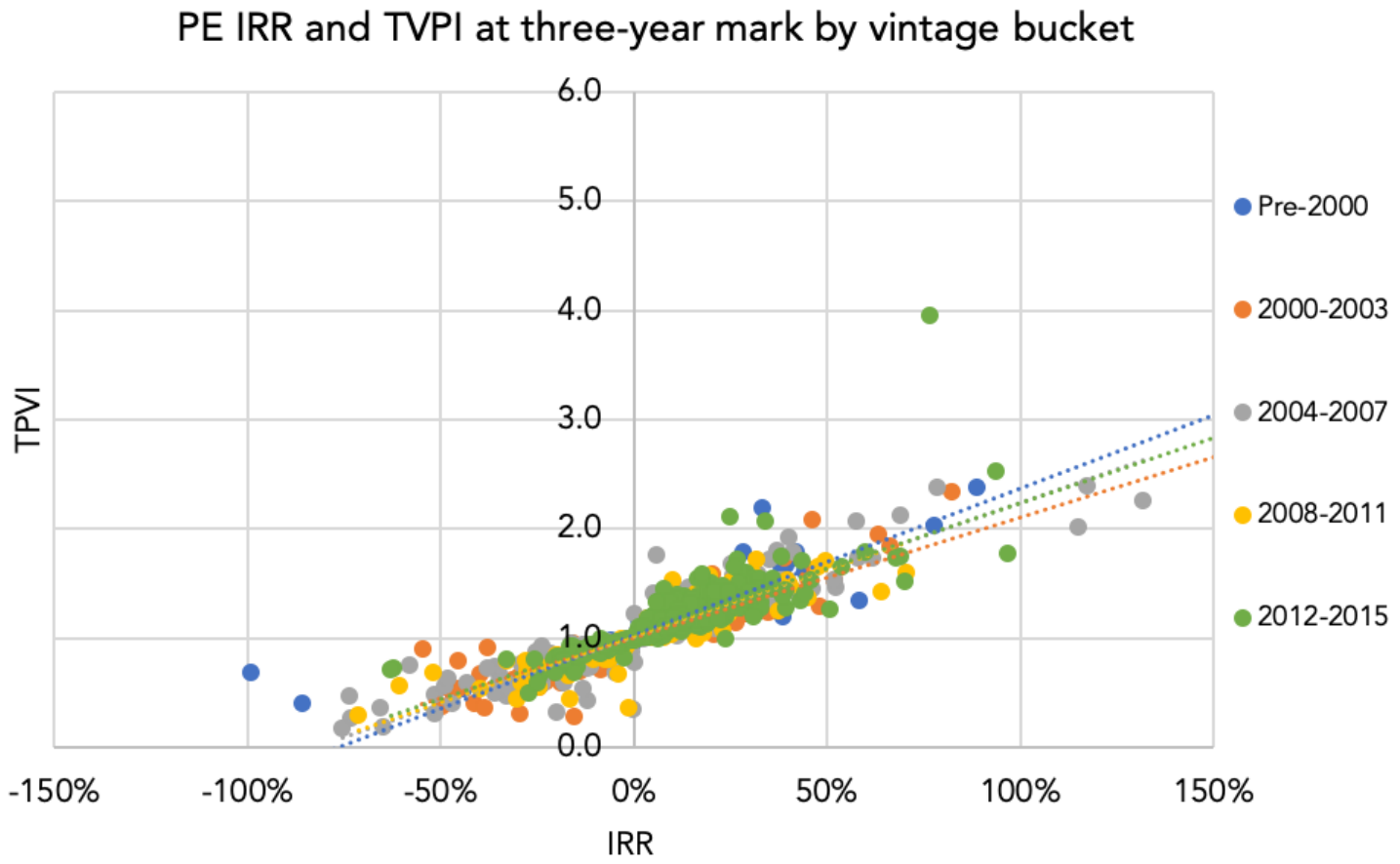
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Are IRRs inflated?

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Download PitchBook's Report here.

It's a slightly different question than asking whether IRRs are trustworthy in general. That debate has been around for years and will continue to be. The inflation question is being asked a bit louder nowadays, thanks to a renewed focus on subscription credit lines. Investors use them to streamline capital calls between their funds and their LPs and speed along near-term funding obligations. The terms on those lines have begun to loosen, and some GPs are reportedly taking advantage of that flexibility to artificially inflate IRRs—by 3% a year, according to some estimates. For what it's worth, the ILPA, a prominent LP trade group, estimates their impact at less than half a percent per year. In any case, PitchBook took a closer look at possible IRR inflation by comparing internal rates of return to cash multiples, which are less manipulatable because the timing of cash flows is taken out of the equation.

Our recap is extensive, and the full Benchmark Report (just released this week) goes into much more detail. The short answer: We found no evidence that subscription lines are being used to manipulate IRRs when we looked at newer vintages. At first glance, the comparison between IRRs and TVPIs strongly suggested they were

inflated, as there appeared to be a clear disconnect between the two values for the vintage buckets we selected. But younger funds tend to report higher IRRs for a given TVPI level anyway; a shared TVPI of 1.5x between two funds will translate into different IRRs depending on the vintage—the younger of the two will have distributed capital back to LPs quicker, justifying its higher IRR and muddying the water on the inflation question. To control for that, we isolated fund performance at the three-year mark for all vintages in the 2012-2015 bucket. Those numbers, graphed above, came in much tighter, suggesting that the apparent inflation in IRR values essentially disappears on an apples-to-apples comparison. In other words, the numbers straighten out when you observe funds at similar stages in their lives, and the correlation proved consistent across vintage buckets when we examined the 5-, 7-, 10- and 12-year marks, as well. IRRs are an imperfect measuring stick—a wiser way to consider them is in conjunction with cash multiples, and deemphasizing their importance until the fund is fully invested.

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